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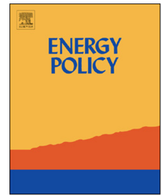

Institutional analysis and the “resource curse” in developing countries

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H I G H L I G H T S

- The institutional strengthening is part of the solution for the resource curse.
- We observed a failure to adhere to Law 7.990/89 of the producer municipalities.
- The implementation of fundamental rights was not significant.
- The producer municipalities studied were not transparent.
- There are evidences of the resource curse in the producer municipalities studied.

A R T I C L E I N F O

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A B S T R A C T

The present article examines the recent advances reported in the literature regarding the mechanisms underlying the “resource curse” in developing countries. By analyzing the Rule of Law Index, we investigated how the institutions responsible for allocating hydrocarbon royalties can help minimize the effects of the resource curse. We used a qualitative methodology based on case studies. The results show that evidence of legal violations on the part of these institutions and the lack of tools in resource-rich developing countries to uphold basic social and economic rights are associated with the resource curse. Our findings suggest that strengthening the institutions, closer monitoring of oil revenue allocations, and public participation can help to alleviate the resource curse.

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1. Introduction

Empirical analyses based on a survey of historical GDP data from countries that have been exporting fossil fuels since the 1970s, including oil and gas, have demonstrated that an abundance of natural resources and economic growth are not positively correlated, which has become known in the literature as the “resource curse” or the “paradox of plenty” (Mikesell, 1997; Auty and Gelb, 1986; Conway and Gelb, 1988; Gelb et al., 1988; Auty, 1988, 1991a, 1991b, 2003, 2005; Sachs and Warner, 1995, 1997, 1999, 2001; Sala-I-Martin, 1997; Doppelhofer et al., 2000).

However, other theorists criticize this perspective because it is solely based on economic growth. These theorists argue that studies based on these theories have not adequately distinguished between economic growth and economic development and that there is insufficient evidence to conclude that resource exporting activities detrimentally affect the development of resource-rich countries (Davis, 1995, 2004; Davis and Tilton, 2005; Lederman and Maloney, 2007; Brunnschweiler, 2008).

Despite these objections, the views of the early theorists on the existence of the resource curse in countries rich in natural resources have prevailed, and several recent studies have indicated the role of strong institutions in helping these countries escape the resource curse (Sala-I-Martin and Subramanian, 2003; World Bank, 2007a, 2007b, 2008; Mehlum et al., 2006; Charlier and N'cho-Oguie (2009); Okeke, 2008).

Stevens and Dietsche (2008) argue that the current emphasis on institutions as potential solutions for the resource curse ignores the circumstances under which the institutions are formed as well as how they change. North (1990) discusses the institutional strengthening within the context of historical and structural changes.

The present study analyzes the institutional processes involved in allocating natural resource revenues and the measures that minimize the effects of the resource curse. Using more robust definitions of what constitutes the resource curse and its relationship with institutional changes, we introduce a methodology based on the Rule of Law Index, demonstrating its importance as a tool to reduce the risks and effects of the resource curse. The present article is divided into 4 sections. Section 2 briefly

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describes the theoretical framework used. Section 3 describes a case study involving an institutional analysis of the Brazilian oil industry. Section 4 details the results. Section 5 presents the conclusions..

2. The resource curse concept and its institutional dimensions

In the late 1980s, several studies on the impact of the natural resource sectors on mineral-exporting economies gathered evidence from the international community that demonstrated that little to no economic growth was achieved in these countries over an extended time span. In response to this evidence, researchers began to conduct empirical studies and analyses to identify the causes and characteristics of the resource curse (Sachs and Warner, 1995, 1999, 2001; Mikesell, 1997; Auty and Gelb, 1986; Conway and Gelb, 1988).

The first of these studies, written by Alan Gelb of the World Bank and published in 1988, was titled "Oil Windfalls: Blessing or Curse?" Gelb's analysis demonstrated that despite oil price increases during the 1970s, the economic circumstances of oil-exporting countries worsened. Gelb concluded that the economic situation in these countries would be healthier if the oil prices had remained steady. According to Gelb, the boom initially experienced by these countries when oil prices rose, which led to the accumulation of capital, dissipated rapidly when prices fell in the 1980s.

In a series of articles and case studies, including his book "*Sustaining Development in Mineral Economies*: *the resource curse thesis*", Auty (1988, 1991a, 1991b, 2003, 2005) showed that some exporting countries did not respond well to the commercial impacts of the oil price shocks in the 1970s. Despite an initial surge, industries based on mineral resources experienced disappointing economic growth and negative responses to structural changes in the mineral economy.

Neary and Van wijnbergen (1986) discussed the macroeconomic effects of high oil price volatility on producing countries. Sachs and Warner (1997) reported evidence that manufacturing exports in countries with abundant resources tend to grow more slowly than in natural-resource-poor countries.

Corden and Neary (1982) and Sachs and Warner (1999) found evidence that countries with abundant natural resources tend to have well-developed service sectors and poorly developed manufacturing sectors compared to poor countries without natural resources.

Empirical analyses demonstrated that the existence and exploitation of mineral resources per se does not guarantee economic growth or decreased poverty rates in these countries. The wealth generated by mineral production has not contributed to strong economic performance in the producing countries. This phenomenon has become known as the "resource curse" or the "paradox of plenty" (Andrews, 2007).

Melby (2008), Bacon and Tordo (2006), and Stevens (2003) described the resource curse as a form of economic decline that can arise from the following conditions: (i) increased real exchange rates in response to income from natural resource exports, depressing other economic sectors (such as agriculture and industry) because of the new flow of resources (a process known as "Dutch Disease"); (ii) an increase in short-term inflation; (iii) reduced domestic consumption capacity resulting from increased commodity prices; (iv) weak controls on public expenditures; (v) increased corruption; and (vi) increased political and economic dependence on the income provided by the production and exporting of natural resources.

Some theorists have emphasized the evidence that institutional quality determines the presence or absence of the resource curse. Thus, the combination of weak institutions with an abundance of natural resources can lead to the occurrence of this phenomenon (Mehlum et al., 2006). These authors proposed institutional analyses as a means to address the negative effects of natural resource exploration on producing countries (Stevens and Dietsche, 2008; Mehlum et al., 2006).

The present paper is also based on the premise that the resource curse is a phenomenon involving both economic consequences and institutional integrity. The resource curse can be described as the phenomenon by which oil-producing countries or localities do not receive the economic and social benefits expected from the wealth generated by the hydrocarbon industry either directly, through the stimulation of the local and national economy, or indirectly, through increased tax revenues as a result of government involvement. This latter factor is the subject of the present study.

In principle, one would expect that the wealth generated by the hydrocarbon industry would contribute to the development of localities that experience a boom in natural resources. However, this assumption does not always hold true, and careful decisions must be made to reverse the negative effects of the resource curse.

The resource curse is an institutional and economic phenomenon. Effective tools with which to identify the presence of the resource curse and the means to adequately manage and govern resource exploitation are essential to addressing this problem and preventing its occurrence in areas that experience natural resource booms.

Davis and Tilton (2005) and Vinod and Kaushik (2007) noted that experts on the topic have focused on adequate government and whether there is an assurance that the income generated by resource exports will be directed toward investments that promote development. On the topic of adequate government, these authors described solutions that require adequate incentives, including a clear definition of property rights; an internal political structure with rules to prevent corruption, waste, rent seeking, and other behaviors that are inappropriate in the public sector; and international pressure associated with the availability of loans from international financial organizations such as the International Monetary Fund (IMF).

Sala-I-Martin and Subramanian (2003) maintained that one of the strategies that companies could adopt would be to transparently make revenue payments by publishing them, thus causing governments that are not committed to wise spending to lose international assistance. These authors also proposed that more of the revenue be given directly to the citizens and less to the government and that mineral companies provide services for the locations impacted by their operations.

According to Stevens and Dietsche (2008), transparency concerning the dispersal of revenues is essential for monitoring, which also includes the creation of incentives and the means for popular participation in allocating and evaluating revenue expenditures. Thus, institutional performance evaluation constitutes a mechanism with which to determine how the government utilizes the revenue. Thus, institutional integrity becomes part of the solution for managing the risks of the resource curse.

Based on the principles of submission to the law, transparency, and the protection of human rights, the present paper analyzes the behavior of municipal executives with regard to the implementation of laws concerning recipients of the public distribution of hydrocarbon royalties. This study also assumes that the municipal executive knows and submits to the Brazilian hydrocarbon laws. In the present study, the rule of law implies that the municipal executive power directs the hydrocarbon revenues in its budgetary expenses in accordance with the law, transparently, and in a way that protects human rights, including social and economic rights.

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